Department of the Treasury

For the Year Ended
June 30, 2002

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

December 19, 2002

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 2002.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies which are detailed in the Results of the Audit section of this report. The department's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/mb
02/098

State of Tennessee

Audit Highlights

Comptroller of the Treasury Division of State Audit

Financial and Compliance Audit
Department of the Treasury
For the Year Ended June 30, 2002

AUDIT OBJECTIVES

The objectives of the audit were to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Flexible Benefits Plan, the Baccalaureate Education System Trust-Educational Services Plan, and the State Pooled Investment Fund; to determine compliance with certain provisions of laws, regulations, contracts, and grants; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

The Wire Room Manager's Access to the Federal Reserve's Fedline Terminals Was Not Adequately Controlled
The Department of the Treasury maintains a secure room known as the wire room, from which electronic funds are disbursed and received. The Wire Room Manager had the ability to transfer funds using the Federal Reserve's Fedline terminals with no verification by another employee in the wire room. This improper access would allow for the Wire Room Manager to transfer funds from the state's Federal Reserve account to an unauthorized account with no other employee's involvement. The security settings for the Fedline terminals should require the involvement of two employees to send a wire transfer (page 11).

Earnings of the Baccalaureate Education System Trust, Educational Services Plan Were Reduced Because the Department of the Treasury Acted Before a Contract Was Obtained
During the audit period, the department was involved in contract negotiations to transfer management of the program's bond portfolio to an external manager. Management liquidated the program's current bond holdings before an agreement was reached. Subsequently, contract negotiations stalled, and no agreement was reached. As a result,

assets were not invested within the asset ranges prescribed in the Board of Trustees' normal investment policy for an 11-month period, and earnings were reduced. If the department seeks another manager for the program's funds in the future, investments should not be sold until all parties approve a contract (page 15).

INTERNAL CONTROL AND COMPLIANCE FINDINGS

The Department of the Treasury Overpaid Criminal Injury Compensation Program Claimants

The Criminal Injury Compensation Program was established to provide financial help to persons who are innocent victims of crime. Two overpayments were noted during audit testwork. An overpayment of $2,708.15 occurred when a claimant was reimbursed for costs already paid by an insurance company. Also, an overpayment of $673.20 occurred when a claimant was reimbursed for lost wages at the current pay rate instead of the pay rates in effect during the period of lost wages. The division needs to ensure that sufficient research is performed on each claimant to ensure that the claimant's expenses have not previously been paid by a third party. The pay rates in effect when the claimant missed work should be used to calculate reimbursements for lost wages (page 12).

The Collateral Pool Board and the Department of the Treasury Should Ensure That Annual Reports Required From Participating Financial Institutions Are Received in a Timely Manner*

The required annual reports from financial institutions are used to provide assurance that the institutions have reported all public deposits held and pledged sufficient collateral for the public deposits held. However, some annual reports are not being received by the due date. It appears that the department lacks adequate enforcement procedures to ensure that required reports are completed and submitted to the department (page 14).

***** This finding is repeated from the prior audit.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, please contact

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Audit Report
Department of the Treasury
For the Year Ended June 30, 2002

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For the Year Ended June 30, 2002

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Department of the Treasury. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated,* which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The State Treasurer, a constitutional officer, is elected by a joint session of the General Assembly for a two-year term. Although no duties are prescribed by the constitution, the functions and duties of the office are assigned through various statutes. These functions and duties include maintaining accountability for and management of public funds and administering the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Uniform Disposition of Unclaimed Property Act, the Criminal Injuries Compensation Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, and the state's Deferred Compensation and Flexible Benefits plans. The Treasurer also administers the settlement of claims against the state through the Tennessee Claims Commission and the Division of Claims Administration.

The Treasurer is required by statute to be a member of many boards and commissions, including the following:

Board of Equalization
Board of Trustees of the Tennessee Consolidated Retirement System
Funding Board
Public Records Commission
State Building Commission
State Insurance Committee
State School Bond Authority

Tennessee Competitive Export Corporation
Tennessee Housing Development Agency
Tennessee Local Development Authority
Tennessee Student Assistance Corporation

ORGANIZATION

The department is divided into 11 major sections: Staff Services, Investments, Baccalaureate Education System Trust (BEST), Information Systems, Records Management, State Trust and Lock Box, Tennessee Consolidated Retirement System (TCRS), Accounting, Unclaimed Property, Claims Administration, and Risk Management. The TCRS is audited and reported on separately.

The **Staff Services** section includes personnel administration, budgeting and fiscal control, administrative services, research and development of special projects, internal audit, and legal services.

The **Investments** section invests the pension fund to maximize the return on investments and to protect the retirement system's assets. This section also invests the state's available cash in certificates of deposit in state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and agency obligations, and certain obligations of the State of Tennessee.

The **BEST** section is responsible for the operation of the state's prepaid college tuition plan (Educational Services Plan) and college savings plan (Educational Savings Plan).

The **Information Systems** section provides the department with data processing services. The **Records Management** section provides physical facilities management, forms control and copying, and safekeeeping. **State Trust and Lock Box** is responsible for remittance receiving and the operation of the Federal Reserve wire transfer facility used to send, receive, and transfer funds for the State of Tennessee.

The **Accounting** section is responsible for maintaining detailed accounting records for various programs administered by the department. This includes maintaining general ledger accounting and reporting for the Tennessee Consolidated Retirement System, the Chairs of Excellence Program, the Local Government Investment Pool, the Cash Management Investment Program, the Claims Award Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, and the Baccalaureate Education System Trust. The section is also responsible for reconciling approximately 150 bank accounts and maintaining the state's warrant reconciliation system (Account Reconciliation Package, or ARP).

The **Unclaimed Property** section takes custody of abandoned property (bank accounts, insurance policies, etc.) and attempts to locate the rightful owners or heirs. The Division of **Claims Administration** administers the Workers' Compensation program for state employees and the Criminal Injuries Compensation Fund. The division reviews and determines eligibility for payment from the Criminal Injuries Compensation Fund. Payments are made as funds become available.

The **Risk Management** section administers a variety of insurance programs for the state. These programs provide protection to the state against property damage, boiler explosion, and employee dishonesty.

An organization chart of the department is presented on the following page.

AUDIT SCOPE

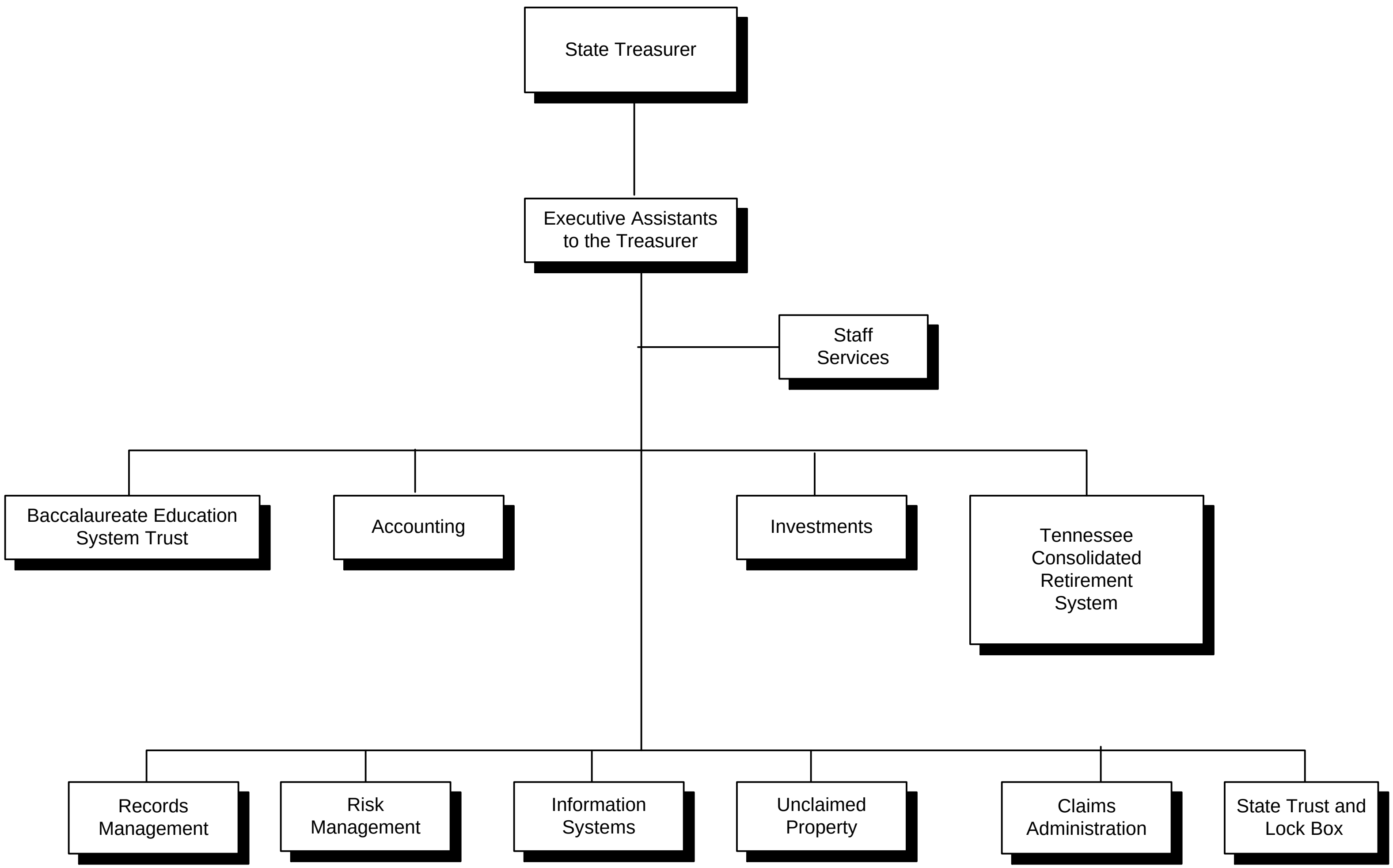
The audit was limited to the period July 1, 2001, through June 30, 2002, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The Department of the Treasury is part of the primary government of the State of Tennessee and is accounted for in the general fund. The department administers the Tennessee Consolidated Retirement System, pension trust funds; the Criminal Injuries Compensation Fund, a special revenue fund; the Claims Award Fund, an internal service fund; the Chairs of Excellence Fund, a permanent fund; the Baccalaureate Education System Trust-Educational Services Plan, a private-purpose trust fund; the Flexible Benefits Plan, an employee benefit trust fund; and the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool).

This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report. The following allotment codes within the State of Tennessee Accounting and Reporting System were covered by this audit:

State Treasurer's Office	309.01
Certified Public Administrators	309.02
Criminal Injuries Compensation	313.03
Claims Award Fund	313.10
Risk Management	313.06
Unclaimed Property	313.20

DEPARTMENT OF THE TREASURY
ORGANIZATION CHART



OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, and the State Pooled Investment Fund;

2. to determine compliance with certain provisions of laws, regulations, contracts, and grants; and

3. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, ***Audits of States, Local Governments, and Non-Profit Organizations*****, it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.**

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The department filed its report with the Department of Audit on June 27, 2002. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDING

The current audit disclosed that the department has corrected the previous audit finding concerning the lack of written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper.

REPEATED AUDIT FINDING

The prior audit report also contained a finding concerning Collateral Pool banks not submitting all required reports. This finding has not been completely resolved and is partially repeated in this report.

OBSERVATIONS AND COMMENTS

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by each June 30. The Department of the Treasury filed its compliance report and implementation plan on July 5, 2002.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Human Rights Commission is the coordinating state agency for the monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, and the State Pooled Investment Fund for the year ended June 30, 2002, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.* Immaterial instances of noncompliance, along with recommendations and management's responses, are included in the findings and recommendations.

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

December 17, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, and the State Pooled Investment Fund as of and for the year ended June 30, 2002, and have issued our reports thereon dated December 17, 2002. As discussed in the notes to these financial statements, the State of Tennessee implemented Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments.* The state also implemented GASB Statement 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The Department of the Treasury and the funds it administers are part of the primary government of the State of Tennessee.

Compliance

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the department's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did, however, note certain immaterial instances of noncompliance that we have included in the Findings and Recommendations section of this report. We also noted certain other less significant instances of noncompliance, which we have reported to the department's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- The Wire Room Manager's access to the Federal Reserve's Fedline terminals was not adequately controlled.
- The Department of the Treasury overpaid Criminal Injury Compensation Program claimants.
- The Collateral Pool Board and the Department of the Treasury should ensure that annual reports required from participating financial institutions are received in a timely manner.
- Earnings of the Baccalaureate Education System Trust, Educational Services Plan were reduced because the Department of the Treasury acted before a contract was obtained.

These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the department's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/th

FINDINGS AND RECOMMENDATIONS

1. The Wire Room Manager's access to the Federal Reserve's Fedline terminals was not adequately controlled

Finding

The Department of the Treasury maintains a secure room known as the wire room, from which electronic funds are disbursed and received. The Wire Room Manager had the ability to transfer funds using the Federal Reserve's Fedline terminals with no verification by another employee in the wire room. The department's procedure is for two wire room employees to be involved in all electronic funds transfers with one employee initiating the transfer and another employee verifying the transfer. The Wire Room Manager had the funds transfer Supervisor function on the Fedline system during the audit period from July 1, 2001, to June 30, 2002. This function has a funds transfer access level to provide the user with the ability to override the verification requirement. The verification requirement is a security setting in place to require that more than one person be involved with the processing of funds transfers.

The Federal Financial Institutions Examination Council (FFIEC) Information Systems (IS) Examination Handbook provides guidance for the proper setup of terminal-related security for the Federal Reserve Fedline terminals. According to Chapter 19 of the handbook,

> No staff members should have the funds transfer (FT) Supervisor or Manager function. These functions have funds transfer access levels that provide the ability to bypass the verification requirement. These access levels should only be activated by the Local Security Administrator in unusual circumstances. The Local Security Administrator should monitor the actions performed using these access levels and then deactivate these levels when the action is complete.

With the ability to override the verification requirement, the Wire Room Manager could transfer funds without having a second person verify the transfer before transmitting to the Federal Reserve. This improper access would allow for the Wire Room Manager to transfer funds from the state's Federal Reserve account to an unauthorized account with no other employee's involvement. Possible detection of an unauthorized transfer would not occur until a reconciliation was performed the following business day between authorized transfers on the department's cash management system and the Federal Reserve funds transfer and subsidiary statement. An employee in the accounting division performs this reconciliation. During a review of several of these reconciliations and activity logs documenting electronic funds disbursements for a given day, no improper electronic funds disbursements were noted. After this improper access was brought to management's attention by the auditors, the funds transfer Supervisor function was removed from the Wire Room Manager's access.

Recommendation

The Director of Information Systems should continue to ensure that the security settings for the Federal Reserve Fedline terminals are within the guidelines and recommendations of the Fedline Electronic Funds Transfer FFIEC IS Examination Handbook.

Management's Comment

Management concurs. In August 2001, management determined that requiring dual approvals on outgoing fund transfers would strengthen existing wire room controls. Accordingly, procedures were changed to require dual approvals on all outgoing fund transfers. In addition, based on staff's understanding of Fedline system security, the system's security settings were changed to require dual approvals. When it was brought to management's attention during the audit that the system security change was not effective, management took immediate action to revise the settings to effectively require dual approval of outgoing fund transfers.

Management emphasizes that during this entire period the manual procedures requiring dual approvals were followed. All outgoing fund transfers were executed only when dual approval was obtained.

2. The Department of the Treasury overpaid Criminal Injury Compensation Program claimants

Finding

The Criminal Injury Compensation Program was established to provide financial help to persons who are innocent victims of crime. Payments made to claimants are intended to defray the costs of medical services, loss of earnings, burial costs, and other pecuniary losses to either the victim of a crime or to the dependents of deceased victims. Applications for Criminal Injury Compensation are filed with the Division of Claims Administration at the Department of the Treasury. The applications and other supporting documentation are reviewed by claims examiners to determine eligibility for compensation.

Testwork on a sample of 42 payments to Criminal Injury Compensation Program claimants revealed two overpayments (5%).

- One claimant was overpaid for a medical expense reimbursement. The claimant submitted a health care provider's statement for $3,602.00, which was paid by the department. However, according to documentation in the claim file, the insurance company had already paid a portion of the claimant's expense. Also, the claimant's initial application indicated that the claimant had health insurance that provided for 70% coverage. This oversight by the claims examiner of the insurance company's prior payment resulted in an overpayment of $2,708.15.

- Another claimant was overpaid for lost wages based on the support that accompanied the claim. Section 29-13-107(1), *Tennessee Code Annotated*, requires that lost wages be awarded under the workers' compensation statutes and that the pay rate be 85% of the claimant's average weekly wage. Section 50-6-102(2)(A), *Tennessee Code Annotated*, states that "average weekly wages means the earnings of the injured employee in the employment in which the injured employee was working at the time of the injury." However, the claims examiner used the $9.08 pay rate that was in effect at the time the claim was filed instead of using the pay rates of $6.88 and $7.43 in effect during the period of lost wages. The employer's statement of lost wages stated that the $9.08 rate was the current pay rate and the other rates were in effect when the time was missed. This error resulted in an overpayment of $673.20.

The total amount of criminal injury overpayments for the errors noted above was $3,381.35 out of a total of $83,909.69 tested.

After the overpayments were brought to management's attention by the auditors, the Criminal Injury Compensation Program staff began seeking recovery of the overpayments.

Recommendation

The Supervisor of Criminal Injury should ensure that sufficient research is performed on each claimant to ensure that the expenses for which the claimant is seeking reimbursement have not previously been paid by the department or a third party. When reimbursing claimants for lost wages, the pay rates in effect when the claimant missed work should be used. The division should continue attempts to recover the overpayments from the related claimants.

Management's Comment

Management concurs. To minimize the opportunity for errors to occur in the claim payment process, existing procedures require that each payment request be reviewed and approved by two different staff members. In each case cited above, this procedure was followed. Notwithstanding staff's compliance with existing procedures, the errors cited in the finding occurred. Management will emphasize to all staff that the appropriate level of research should be performed when a claimant is seeking reimbursement that involves a third party. Further, management will emphasize that lost wages should be reimbursed at the pay rate in effect when the work was missed.

3. **<u>The Collateral Pool Board and the Department of the Treasury should ensure that annual reports required from participating financial institutions are received in a timely manner</u>**

Finding

The Collateral Pool was established in 1990 to allow financial institutions and governments statewide to participate in a collateral pool to provide an effective, low-risk system of collateralizing public funds. *Tennessee Code Annotated* prescribed the formation of the board to oversee the operations of the pool and attached the board, for administrative purposes, to the Department of the Treasury. The department began administering the pool in November 1995. Currently, the pool has approximately 53 participating financial institutions.

The Collateral Pool currently requires annual reports from participating financial institutions. These reports provide assurance that the institutions have reported all public deposits held and pledged sufficient collateral for the public deposits held. A finding in the prior audit noted that not all required reports were received and that some reports were not received by the due date. Testwork for the current audit revealed that problems with missing or late reports had been reduced since the prior audit. However, some required reports are still not being received by the due date.

Pursuant to Rule 1700-4-1-.07(3) adopted by the Collateral Pool Board, every qualified public depository shall file an annual report no later than March 31 of each year. The annual report consists of two reports, the Annual Management Certification and the Annual Certification by Independent Auditors. The Annual Management Certification requires management to certify that their financial institution has the systems and controls in place to ensure that public deposits are properly identified and reported. The Annual Certification by Independent Auditors requires an independent auditor to certify that he/she has examined and tested the institution's systems and procedures that identify and report public deposits and has found them effective, with any deficiencies noted in the audit report. The following exceptions were noted regarding the annual reporting requirements:

- Two of 31 institutions tested (6%) failed to submit the complete annual report by the due date. The reports were submitted 31 to 43 days late, or an average of 37 days late.

It was recommended in the prior audit finding that the Collateral Pool Board adopt enforcement procedures to help ensure that all required reports are submitted to the department by the due date and are properly completed. Management stated in their response to the finding that Treasury's staff was to outline a series of recommendations for better enforcement to be considered at the next meeting of the Board, probably in March 2002. The auditor observed the list of recommendations prepared by Treasury's staff. However, as of November 2002, the Collateral Pool Board has not met to address the list of recommendations.

The reports from Collateral Pool participants are necessary to determine if all public deposits are sufficiently collateralized. If a participating financial institution becomes insolvent, the other Collateral Pool members are assessed for any collateral deficiency of the insolvent member. As a result, the risk of loss to a Collateral Pool member is increased if other pool members have not pledged collateral at the required target level.

Recommendation

The Collateral Pool Board should adopt enforcement procedures to help ensure that all required reports are submitted to the department by the due date and are properly completed. The enforcement procedures should be sufficient to strongly encourage compliance with reporting requirements.

Management's Comment

Management concurs. At the next meeting of the Collateral Pool Board, enforcement procedures will be considered by the Board. It should be noted that failure to report timely does not put public deposits at risk; the risk of default is borne by financial institutions participating in the pool. Moreover, the risk of default by an institution in the collateral pool is remote because Treasury staff closely monitors the financial condition of each institution. The Collateral Pool Board has adopted stringent financial criteria for institutions to participate in the pool and for the level of required collateral. The financial data reviewed include capital position, strength of earnings, asset quality, and liquidity.

4. Earnings of the Baccalaureate Education System Trust, Educational Services Plan were reduced because the Department of the Treasury acted before a contract was obtained

Finding

The Baccalaurate Education System Trust (BEST), Educational Services Plan is a tuition program under which parents and other interested persons may assist students in saving for tuition costs of attending colleges and universities. The plan allows anyone to pay for higher education tuition in advance on behalf of a beneficiary through the purchase of tuition units. The cost for one academic year of tuition at the average-priced, four-year undergraduate Tennessee public university will be covered by approximately 100 tuition units. The Department of the Treasury manages the investments made with the funds from tuition unit purchases to keep up with the increases in state university costs.

During the audit period, the department was involved in contract negotiations with TIAA-CREF Tuition Financing, Inc., to assume the responsibility of managing the program's investment in bonds. The change in management of the bond portfolio was approved by the Board of Trustees at its June 21, 2001, meeting. TIAA-CREF already managed the BEST

Educational Savings Plan that has no Tennessee residency requirements and is an alternative to the Educational Services Plan. Management assumed that an agreement would quickly be reached and proceeded to liquidate the bond holdings and invest in cash equivalents. However, management acted before an agreement was reached. Subsequently, contract negotiations stalled and TIAA-CREF did not assume management of the bond portfolio.

As a result of the bond liquidation discussed above, the BEST assets were not invested within the asset ranges prescribed in the Board of Trustees' normal investment policy from July 27, 2001, to June 25, 2002. The established ranges are 20-50% for equity securities, 50-75% for bonds, and 2-15% for cash equivalents. In July 2001, the department began selling all of the program's bonds in anticipation of TIAA-CREF assuming management of the bond portfolio. By August 2, 2001, all bonds had been liquidated. The portfolio did not own any bonds again until $20,000,000 of United States Treasury Notes were purchased on June 26, 2002, bringing the portfolio back within the approved asset ranges. Over 60% of the program's investments were in cash equivalents during this 11-month period with the remainder of the program's funds invested in equities.

Earnings on the cash equivalents and bond investments held by the program during the audit period of July 1, 2001, to June 30, 2002, were $763,326. This amounts to a return of approximately 3.81%. If the program had been at least 50% invested in bonds during the entire period, portfolio earnings would have been higher. Because management assumed an agreement would be reached and liquidated the bond holdings rather than waiting for a contract to be finalized, earnings were reduced.

Recommendation

If the department seeks another manager for the program's funds in the future, investments should not be sold until all parties approve a contract.

Management's Comment

Management concurs. This was a rare event relative to the transfer of funds from internal management to external management. In the future, the department will not take such an action prior to the execution of a contract.